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No. 907

In the Supreme Court of the United States

OCTOBER TERM, 1958

H. SCHAEFFER, JR., and OPAL R. SCHAEFFER, Husband and Wife, PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

MEMORANDUM FOR THE RESPONDENT

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CHARLES K. RICE
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OPINIONS BELOW

The memorandum opinion of the Tax Court (R. 100a-117a) is not reported. The opinion of the Court of Appeals is reported at 258 F. 2d 861.

JURISDICTION

The judgment of the Court of Appeals was entered on August 20, 1958. A timely petition for rehearing was denied on December 12, 1958. By order of Mr. Justice Stewart, dated March 6, 1959, the time within which to petition for a writ of certiorari was extended to

May 11, 1959. The petition for a writ of certiorari was filed on that date. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

QUESTION PRESENTED

Whether an accrual basis taxpayer[1] who sells used automobiles on credit and discounts his customers' obligations with finance companies, realizing part of his gain in cash and part in the form of credits—the latter portion to be ultimately satisfied either by payment in cash or by offset against the taxpayer's obligations—is required to report the amount of gain so credited (as well as the gain in cash) as income for the year in which the sales and credits are made.

STATUTES INVOLVED

Sections 22(a), 41 and 42(a) of the Internal Revenue Code of 1939 are set forth in the Appendix, *infra*, pp. 6-7.

STATEMENT

The taxpayer and his wife filed joint federal income tax returns for 1952 and 1953 with the Director of Internal Revenue for the District of Tennessee. In those years, the taxpayer operated a retail used automobile business in Memphis as an individual proprietor, under the name J & S Motors. The books were kept on an accrual basis. During 1952 and 1953, purchasers of automobiles under conditional sales contracts executed notes which the taxpayer sold without recourse to Memphis Bank and Trust Company and to Guardian Discount Company. (R. 101a.)

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[1] For convenience J. H. Schaeffer, Jr. will be referred to herein as the taxpayer, although his wife, Opal R. Schaeffer, is also a petitioner inasmuch as she filed joint returns with her husband for the taxable years involved.

When the notes were sold, the finance companies withheld a portion of the proceeds, crediting the same to the taxpayer in separate and distinct accounts known as "loss reserve" and "special reserve" or "rebate" accounts. (R. 101a-102a.) An agreement between the taxpayer and Memphis executed on November 30, 1951 (R. 104a-106a), provided for the sale of such notes on a non-recourse basis, payment from the reserve account to be made to taxpayer quarterly of all amounts over 4% of the total amounts outstanding on notes purchased from the taxpayer by the company, but no payment of any amount from the reserve to be made as long as the taxpayer was indebted to the company.[2]

Both finance companies made current entries in a loss reserve account in the taxpayer's name, crediting a percentage of cash advanced on the discounted notes and debiting repossession losses. The balances in these accounts were designed to give the finance companies

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[2] A separate agreement of the same date set out the understanding with respect to the reserve as follows (R. 107a):

> On 12 month contracts we will retain 6% per annum of cash advance, plus insurance. We will set up in a loss reserve 2% of the cash advance. The remainder will be rebates. On contracts financed for a longer period of time, the same agreement will apply on a proportionate basis. In any transaction we will retain a $20.00 minimum charge. The loss reserve will be payable quarterly all over 4% of the outstandings.

As the result of a decline in the used car market, the method of discounting paper was changed and the amount allocable to the loss reserve was increased by an amended retail reserve agreement between the taxpayer and Guardian dated May 5, 1953. (Ex. 5, R. 25a, 107a-108a.) This agreement was considered as binding also on Memphis. The taxpayer had had no written agreement with Guardian prior to that agreement, but in view of the fact that Memphis and Guardian were guided by the same people, the taxpayer considered that his agreement with Memphis pertained also to Guardian. (R. 108-109a.)

a protection from losses due to the high ratio of repossessions in the used car field. In addition, there was a verbal agreement between the finance companies and the taxpayer that he would further guarantee the companies against loss by repurchasing repossessed cars at a fair retail price. The balances in the loss reserve accounts of the finance companies in 1952 and 1953 did not exceed 4% of the outstanding value of all amounts payable on notes purchased. The taxpayer did not receive any of the loss reserves credited on the books of the finance companies in those years. However, if all of the purchasers of automobiles whose notes were held by the finance companies had met their payments on time, the taxpayer would have been entitled to receive the entire balances in the accumulated loss reserve accounts. (R. 109a-110a.)

The Tax Court and Court of Appeals held that taxpayer's net income for the years in question was properly increased by the amount of the net increases[3] in the loss reserve accounts. (R. 113a-117a.)

DISCUSSION

The sole issue in this case is when an accrual basis taxpayer shall treat as income amounts credited to reserve accounts held in his name by finance companies with which he does business. As the taxpayer points out (Pet. 5), the same issue is involved in Nos. 380, 381 and 512, *Commissioner* v. *Hansen, Commissioner* v.

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[3] The Commissioner did not include in the taxpayer's taxable income all the amounts added to the loss reserve accounts in a particular year, but only the net increases in such accounts after allowing for actual losses arising out of defaults occurring in each of the taxable years. (R. 26a-28a.)

Glover, and *Baird* v. *Commissioner*,[4] now awaiting decision by this Court. The petition suggests (Pet. 5) that the Court defer action in the instant case pending disposition on the merits in the *Hansen*, *Glover* and *Baird* cases. We agree with this suggestion, having, indeed, made similar suggestions in petitions for certiorari filed in other cases involving this same issue. See Nos. 561 and 761, *United States* v. *Hine Pontiac* and *United States* v. *Colonial Chevrolet Corporation*.

Respectfully submitted,

J. LEE RANKIN,
Solicitor General.

CHARLES K. RICE,
Assistant Attorney General.

JOSEPH F. GOETTEN,
CAROLYN R. JUST,
Attorneys.

JUNE 1959.

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[4] Taxpayer inadvertently states (Pet. 2) that *Baird* v. *Commissioner*, 256 F. 2d 918 (C.A. 7th), certiorari granted, 358 U.S. 918, is in conflict with the decision of the court below. He apparently intended to refer to *Hansen* v. *Commissioner*, 258 F. 2d 585 (C.A. 9th), certiorari granted, 358 U.S. 879.

APPENDIX

Internal Revenue Code of 1939:

SEC. 22. GROSS INCOME.

(a) *General Definition.*—"Gross income" includes gains, profits, and income derived from salaries, wages, or compensation for personal service, of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. * * *

* * * * *

(26 U.S.C. 1952 ed., Sec. 22.)

SEC. 41. GENERAL RULE.

The net income shall be computed upon the basis of the taxpayer's annual accounting period (fiscal year or calendar year, as the case may be) in accordance with the method of accounting regularly employed in keeping the books of such taxpayer; but if no such method of accounting has been so employed, or if the method employed does not clearly reflect the income, the computation shall be made in accordance with such method as in the opinion of the Commissioner does clearly reflect the income. If the taxpayer's annual accounting period is other than a fiscal year as defined in section 48 or if the taxpayer has no annual accounting period or does not keep books, the net income shall be computed on the basis of the calendar year.

(26 U.S.C. 1952 ed., Sec. 41.)

SEC. 42 [as amended by Sec. 114, Revenue Act of 1941, c. 412, 55 Stat. 687]. PERIOD IN WHICH ITEMS OF GROSS INCOME INCLUDED.

(a) *General Rule.*—The amount of all items of gross income shall be included in the gross income for the taxable year in which received by the taxpayer, unless, under methods of accounting permitted under section 41, any such amounts are to be properly accounted for as of a different period. * * *

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(26 U.S.C. 1952 ed., Sec. 42.)

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